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CHAPTER 6: THE POLITICAL  
ECONOMY OF THE *BALADI*  
BREAD SUPPLY CHAIN



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“Find out the cause of this effect,  
Or rather say, the cause of this defect,  
For this effect defective comes by cause.”

Shakespeare, *Hamlet Act II, Scene 2*

Previous chapters have unpacked the roles (Chapter 3), functions (Chapter 4) and distortions (Chapter 5) associated with the operations of the *baladi* bread subsidy regime. Key emphasis was placed on identifying actors at each step of the supply chain. This shed light on how the incentives of various actors are structured and how they derive rents from the system.<sup>156</sup> The institutional details that emerged at the micro-level revealed new insights into the behaviour of a small group of intermediaries in the system and the potential opportunities for distortions to occur. The impetus behind the analysis is the staunch opposition of some of these intermediaries to any reforms that would jeopardise their source of rents, as was seen with the *baladi* bread reforms initiated by President Morsi’s cabinet in early 2013.

Typically, subsidy reform is framed within the broader narrative of the politics of the consumer in the sense that subsidy reform will harm the final consumer and can, therefore, be politically costly.<sup>157</sup> However, the study of the entire *baladi* bread subsidy regime gives nuances to that and brings in the politics of the intermediaries as insiders that are resistant to reform. Each intermediary benefits from the subsidy regime either legally, through supply chain operations, or illegally, through distortions in the supply chain. These benefits can be studied in the framework of rents and development from the political economy literature.

The objectives of this chapter are then twofold: the first section looks at how the broader political economy literature, in particular, that on rent-seeking, helps to explain the operation of the *baladi* bread regime. The second section will then consider ways in which the subsidy regime may feed back into the broader political economy of Egypt.

A political economy angle is an opportunity to study the *baladi* bread supply chain by focusing on non-obvious factors that can throw up more details on the nature of the reform process. The detailed study of the system revealed how the *baladi* bread subsidy is guided by the interests and incentives of intermediaries throughout the supply chain.

**156.** In standard economic theory, “rent” is defined as the receipt of payment from unearned income streams.

**157.** See: World Bank, 2012; World Food Programme, 2010; Poulin et al., 2002; Kherallah et al., 2000; Omran, 1997.

These intermediaries sought to maintain administrative arrangements to sustain their rent streams. In this sense, the state subsidises not just the final product – the *baladi* bread – but also the entire supply chain, which effectively makes intermediaries in the system important beneficiaries of the subsidy regime.

The political economy behind resistance to subsidy reform is then best understood by a detailed study of the interests and incentives of the actors partaking in rent-seeking activities at each stage of the *baladi* bread supply chain.

By looking at the *baladi* bread system in a detailed fashion, the research findings in this book provide a more differentiated view of reality and the world of intermediaries in the supply chain. This process provides a new window into understanding the resistance to large-scale subsidy reforms in Egypt. The findings on rentierism and complex institutional structures support the insights from the modern political economy analysis by Douglas North (1991, 2009), Acemoglu and Robinson (2006, 2008) and Paul Pierson (2004).

In a way, the operations of the *baladi* bread supply chain are akin to the makeup of the proverbial onion, where multiple layers need to be peeled back to reveal the inner complexity and workings of the system. In fact, as one peels off these layers, a larger and more complex world of intermediaries emerges.

The remainder of the chapter is structured into two sections: the first part looks at rent-seeking behaviour in the *baladi* bread regime and the second part situates the reforms of the *baladi* bread subsidy within the broader political economy of Egypt.

## 6.1. Rent-seeking in the *baladi* bread regime

The case of the Egyptian *baladi* bread subsidy is archetypal of rent-seeking behaviour. In this instance, rent-seeking emerges from a wide range of profitable economic activities in the system. This section consolidates rent-seeking behaviour in the *baladi* bread supply chain by bringing in two forms of distortions studied in Chapter 5 – leakages and poor regulation. These rents occur as a result of strong incentives for actors to exploit price differences for subsidised and unsubsidised goods in the system and the lack of control by the state over their activities. The analysis is structured into two groups: rent-seeking by intermediaries through leakages in the supply chain and rent-seeking by intermediaries as a result of poor regulation. At the end of the section, the incentives and functions of intermediaries are linked with the broader rent-seeking literature in political economy.

It is worth emphasising that the total number of intermediaries is in fact larger than those that I have included here. This chapter only provides a subset of rent-seekers in the *baladi* bread supply chain, as I was limited by time constraints and the breadth of fieldwork data. Table 4 sums up this process by providing a typology of actors in the supply chain and their rent streams. Future research avenues can use this table to examine similar distortions through the role of other intermediaries in the system. This is just the tip of the iceberg.

### 6.1.1. Rent-seeking through leakages

The first subset of rent-seekers is a group of intermediaries that diverts resources to supplement their income streams through leakages. This group consists of licensed *baladi* bread bakers and millers that would skim off part of their allocated flour quotas to sell it in unsubsidised markets. The incentive to do so is evidenced by the sharp differential between the price of subsidised flour (\$26.5/MT) and the estimated price of flour on the black market (\$160-294/MT). Also the low cost of production payments that are made by the state to sustain the economic activities of bakers and millers coupled with deliveries of low quality wheat and flour impinge on their production quotas.<sup>158</sup> These incentives then create a space for licensed bakers and millers to engage in rent-seeking behaviour.

As a result, a non-negligible portion of the produced *baladi* bread flour fails to reach the end consumer.

Importantly, the heavy reliance of intermediaries on such rent streams creates a substantial social loss in communities that are reliant on supplies of cheap *baladi* bread. The common sight of long bread queues in poor urban neighbourhoods and their propensity at times to break out into violent protests is a testimony to how rents sought by non-targeted beneficiaries can exclude the actual beneficiaries – the end consumer – further down the supply chain.

Leakages caused by the licensed *baladi* bread bakers and millers of *baladi* flour thus testify to how the state's resources for the subsidy can be misappropriated for other purposes. The high price differential, poor policymaking and lack of oversight by the state are all factors that contribute to exacerbating leakages in the *baladi* bread supply chain. The next section turns to rent-seeking behaviour as a result of poor regulation in the system.

### 6.1.2. Rent-seeking through poor regulation

The second group of intermediaries endemically exploits poor state regulation to seek out rents. Bakery inspectors, mayors and MPs and private traders make use of discretions and distortions inherent in the *baladi* bread system to divert resources. Each group is examined separately below.

#### *Bakery inspectors*

Bakery inspectors acting on behalf of the MSIT are part of a larger bureaucratic apparatus engaged in monitoring the *baladi* bread supply chain. In this instance, they have a strong incentive to allow bakers to leak *baladi* bread onto the black market in exchange for a bribe that compensates for their government salary as low-ranking civil servants. Fieldwork data in Chapter 4 has revealed that inspectors would willingly waive some of the illicit practices by licensed bakers in exchange for a financial sum. The loose state oversight of their activities coupled with their authority to strip *baladi* bread bakers of their licence by reporting them to the MSIT puts them in a stronger position to negotiate bribes in their favour.

<sup>158</sup>. In 2013, the state agreed to pay licensed bakers \$18 to process 50 kg of flour into *baladi* bread – well below the potential rents that they could generate from sales of flour on the black market.

By doing so, bakery inspectors end up partaking in a process that perpetuates the leakage of *baladi* bread flour onto the black market, whilst simultaneously manipulating loopholes left by poor state regulation to extract additional rents. The alleged cost allocated by the state for bakery inspectors to check licensed *baladi* bread bakers is then wasted and further contributes to multiplying distortions in the system.

### ***Mayors and MPs***

Local mayors and MPs also exercised their discretionary powers in influencing the allocation of *baladi* bread licences to prospective bakers. As discussed in the poor regulation section of Chapter 5, licences were allocated to prospective *baladi* bread bakers who would vote for the mayor or MP's political party in the next election campaign. The analysis suggested that the successful provision of licences to bakers is linked with political favours by government bureaucrats looking to remain in power. This kind of behaviour confirms that mayors and MPs are privileged insiders in the *baladi* bread system that can misuse their state functions to support their leadership through the preferential allocation of licences.

Basically, the Egyptian political class is also one of the key beneficiaries of the *baladi* bread subsidy. The control by mayors and MPs of licence allocation further explains why it is politically difficult to implement radical reforms to the system. Should they lose their discretionary power in this process they would risk not being re-elected again. This point further reinforces the initial argument that reforms to the *baladi* bread supply chain go beyond the politics of the consumer. Rather, they are also contingent on the politics of intermediaries like mayors and MPs in the system.

### ***Private traders***

Finally, private traders that buy up domestic wheat from local farmers and transport it to government-owned storage facilities are another type of rent-seekers in the *baladi* bread supply chain. These traders exploit the higher price incentive offered by the state to wheat farmers by acting as intermediaries between small landholders and the state. In their capacity as carriers of the domestically produced wheat, they offer the farmer a buying price to transport part of the harvest to open-air facilities. More often than not, the selling price is lower than the marketed price by the state. That is because private traders can favourably negotiate with farmers who would otherwise lack the means to transport the wheat harvest to the state's granaries. This process persists as a result of mandatory state policy for domestic wheat producers to deliver the wheat in order to recoup the higher price incentive.

By operating in a largely uncompetitive local environment, private traders are able to make use of this policy to generate additional rents from the system. Their activities then disenfranchise many of the intended beneficiaries of the incentives put in by the state to increase local wheat production.

Moreover, just as private traders facilitate the transport of domestic wheat, they also draw in additional rents by padding the local harvest

out with cheaply imported wheat from abroad.<sup>159</sup> Between the fields and granaries, private traders maliciously inflate the volume of the harvest by mixing in imported wheat to claim the price premium offered by the state for domestic wheat. Any reform process to the procurement of domestic wheat would have a direct impact on these private traders' income streams.

Although a wide range of reforms have been contemplated at various points to deal with these distortions, they still largely persist across the system. The analysis in fact proves that intermediaries have their own incentive function which often militates against a radical reform of the *baladi* bread system. In order for any reform to succeed it needs to first compensate the rent-seeking intermediaries, otherwise it will be very difficult to implement. This further reinforces the narrative that changes to the *baladi* bread process are underpinned by the politics of intermediaries rather than the conventional narrative focusing on the politics of the consumer in the broader literature.

Based on the above factors, it is clear that all of these intermediaries have a vested interest in preserving the status quo. Some of them are also better mobilised politically (bakers through the Bakery Owners' Division), others are political insiders (mayors and MPs) and some others are well-entrenched bureaucratic intermediaries who control the supply chain (inspectors, private traders). All of these actors are likely to be net losers from any significant reform of the subsidy system. Indeed, that is why such reform is absent despite frequent promises to carry it out.

The combination of these processes therefore highlights why large-scale reforms of the *baladi* bread supply chain have failed to materialise over the years. The sale of *baladi* bread flour on the black market suggests that rents are solicited by specific intermediaries – licensed bakers and millers – to sustain their economic activities. Similarly, the links between bakery inspectors, mayors, MPs and private traders and other actors in *baladi* bread supply chain suggests a classic patron-client relationship that is inherent in rent distribution mechanisms seen in the works of Gordon Tullock (1967) and Anne Krueger (1974) in the rent-seeking literature.

**159.** As noted in previous chapters, the cheap wheat does not need to conform to the state's strict requirements and standards. Low quality wheat can be procured much more cheaply and marketed as locally produced wheat by these traders.

<b>Actors</b>	<b>Source of Rent Streams</b>
Licensed <i>baladi</i> bread bakers	Sales of <i>baladi</i> bread flour on the black market.
Millers of <i>baladi</i> bread flour	Sales of <i>baladi</i> bread flour on the black market.
Bakery inspectors	Bribes from <i>baladi</i> bakeries caught leaking flour onto the black market .
Mayors and MPs	Bakery licences for prospective bakers of <i>baladi</i> bread.
Private Traders	Transport of domestically grown wheat from smallholders to the state's granaries. Sales of cheaply imported wheat that is marketed as local wheat.
Global Authority for Supply Commodities (GASC)	Rents from wheat exporting countries as well as issuing tenders to export wheat from other countries.
Food Industry Holding Company (FIHC)	Rents from colluding private and public sector activities.
Port Authority	Rents from firms to smuggle low-grade wheat into Egypt.
Wheat inspectors	Bribes from millers caught mixing subsidised and unsubsidised wheat quotas.
Senior political bureaucrats	Rents from preferential allocation of quotas to companies where they are major shareholders.
Military	-

Table 4 above provides a typology of actors and their associated rent streams. There are still many black boxes and I have highlighted actors that have been considered in detail in this book. Additional research can examine any of the other intermediaries in the supply chain and how they play a part in distorting the system.

In their capacity as powerful intermediaries, bakers, millers, bakery inspectors, mayors, MPs and private traders confirm how the process of unpacking the *baladi* bread subsidy can contribute to a new understanding of the political economy factors behind resistance to subsidy reforms. Rent-seeking behaviour by various actors in the supply chain becomes a key part of the problem inherent in the *baladi* bread subsidy regime. The next section looks at how the broader literature on rent-seeking in political economy can help better frame this debate.

### **6.1.3. The *baladi* bread subsidy and the broader rent-seeking literature**

Notions of the *baladi* bread subsidy regime can be studied through the lens of political economy. In that case, rent-seeking constitutes a more encompassing framework to link the roles and functions of intermediaries in the *baladi* bread supply chain with notions of rentierism in the literature. Seminal authors in the field like Gordon Tullock, James Buchanan and Anne Krueger provide the backdrop to studies on rent-seeking in the broader political economy literature.

Rent-seeking is a key analytical framework within political economy. It is premised on unearned income streams (i.e. rents) that accrue from the diversion of resources as a result of a more privileged access to the system. The starting point of this literature is often considered to be Gordon Tullock's paper on the "Welfare costs of Tariffs, Monopolies and Theft" in 1967. Also, Anne Krueger's (1974) seminal study on how rents were earned in India and Turkey provided the descriptive term "rent-seeking" for the first time in the political economy literature.

Tullock and Buchanan's (1980) work placed key emphasis on how certain kinds of policy distortions create deadweight losses from the fact that resources have been diverted to an unproductive activity. These early rent-seeking analyses measured social losses from public policies and monopolies. Distortions emerged from rent-seeking behaviour where in the process of investing resources to get a more privileged access to the system, actors created a social loss. Furthermore, in the context of industrial policy in developing countries, Anne Krueger's research noted that rents from import quotas attracted rent-seeking behaviour to create monopolies.

The general insight evidenced by Tullock, Buchanan and others demonstrated that these losses are equal to the profits generated by those that end up obtaining a more privileged access to the system. Subsequent research by Krueger and others affirmed that rents do not actually impose a net social loss on society. Rather, the wealth only shifts from the consumer to the monopolist. In that case, the leakage of *baladi* bread flour shifted the loss of resources from the consumer to the baker or miller.

Rent-seeking is problematic because when a process of quota allocation is in place, considerable investment is made towards unproductive activities that are trying to get access to those quotas. A similar logic was seen with the structure of incentives and functions of mayors, MPs and private traders in the *baladi* bread subsidy as discussed above. The broader rent-seeking literature can then help better inform of the stagnation of reform throughout the supply chain.

The next section now moves on to link the *baladi* bread subsidy programme with the broader political economy of Egypt.

## 6.2. The impact of the *baladi* bread subsidy on the broader political economy in Egypt

As the above discussion suggests, there are multiple types of rent-seekers in the *baladi* bread supply chain. Each of these actors has their own objective function and an interest in preserving the status quo in the system. This unpacking of the supply chain thus provides a new window into understanding the resistance to large-scale subsidy reform in Egypt, yet it seems that the *baladi* bread subsidy shares many features with the Egyptian political economy. In a way, Egypt's *baladi* bread subsidy can be viewed as a microcosm of what is wrong with the country's political economy.

Just as the *baladi* bread subsidy regime is shaped by Egypt's wider political economy, the way in which this subsidy regime operates can shape, in turn, the political landscape of Egypt. The inability of political leaders to grapple with this issue and improve the state of the *baladi* bread subsidy suggests stronger undercurrents that go well beyond the risks of social unrest and widespread hunger.

The pathologies of the Egyptian state are very evident in the operation of the subsidy regime: a centralised state structure, bloated public sector, pervasive regulatory controls, the discretionary role of bureaucratic intermediaries and anti-competitive market practices.<sup>160</sup> Perhaps the underlying role of intermediaries in the *baladi* bread system can be best summarised by describing a visit to the MSIT headquarters in Cairo, the central organisation in charge of administering the subsidy. The derelict building reminiscent of the typical Soviet-style architecture from the 1950s sits on a crowded street in central Cairo. The expanse and breadth of the structure typifies the role of the state as a dominant economic player and the largest employer in the country, as envisioned by members of the Nasserist cabinet long ago.<sup>161</sup> In fact, in 2014, the Egyptian state still **remains** the largest employer in the country with slightly less than 10% of the population (about 7.94 million) employed in various public sector activities.

Somehow, much of what ails Egypt seems to converge in the story of subsidised bread. It speaks to a state that is in many ways stuck in the past, struggling to pull itself into the future, unable or unwilling to conquer corruption or even to persuade actors to care about social gains. Maintaining the status quo rather than economic reforms is seen as the fundamental measure of success for many of the intermediaries in the system. Any attempt at reform is usually avoided or resisted by those who adhere to this measure.

<sup>160</sup>. For a more detailed view on the political economy of Egypt see: Sullivan, D.J. "The Political Economy of Reform in Egypt", *International Journal of Middle East Studies*, vol.22, 1990, pp.317-334.

<sup>161</sup>. Upon arriving, visitors are greeted by two security guards at the gate where they are asked to show some form of identification and disclose the name of the person they are meeting. Then another doorman greets the guest by the entrance of the building to guide them through the maze of halls and offices in the MSIT. The minister's office is located on the fourth floor. A third doorman asks the visitor the purpose of their visit and their scheduled meeting time with the minister. They are then escorted to a waiting room where they find three employees overseeing the affairs of the minister's assistant. And what is more, the role of one of the employees in that room solely entails overseeing the work of the other two.

This underlying resistance to reform then highlights the vagaries of continuing economic crisis and misguided government policies that continue to stunt growth or any attempts at reform of the Egyptian economy.

For instance, between March and June 2013, riots and shortages across Egypt were linked with resistance by bakeries to some of the reforms implemented by the Minister of Supply and Internal Trade to restrict leakage and wastage. The new measures relied on the extensive network of the Muslim Brotherhood in local communities to monitor the activities of bakers. The inability of President Morsi's cabinet to remediate these riots and bread shortages eventually fed into the political temperature that culminated with the interference of the army to depose the president from power in July 2013. These episodes, amongst others, suggest that the *baladi* bread subsidy can play a role in shaping the political landscape of Egypt.

The complex structure of the *baladi* bread supply chain revealed that some intermediaries can block operations and attempts at reform. Although the state may appear to be in charge of a command and control economy where it sets the prices, quotas and licences for *baladi* bread production, it is in fact dependent on an interlocking web of interests that goes well beyond the control of political administrators.

Arguably all of these actors are engaged in the rent-seeking behaviour, yet they have different levels of power across the supply chain. This is significant from a political economy standpoint because the proliferation and subsistence of the above activities over time reinforces the role of select intermediaries as rent-seekers with substantial bargaining power at various stages of the system. More importantly, the way in which the terms are set suggests that only a small group of intermediaries ends up becoming the primary recipient of the state's support and resources.

Evidence from fieldwork data suggests that bakers are one type of actor engaged in differential bargaining power. The formation and existence of the Bakery Owners' Division at the Egyptian Federation of Chambers of Commerce continues to represent the interest of private, licensed *baladi* bread bakers. The division frequently negotiates with the state to agree on a reasonable cost of production payment to cover some of the economic activities of licensed bakeries.<sup>162</sup> However, the recent failure of the former Minister of Supply and Internal Trade, Bassem Ouda, to implement a monitoring system that would ration the supply of *baladi* bread according to a smart-card system suggests otherwise. The state faced a backlash from the Bakery Owners' Division which threatened a nationwide bakers' strike unless the state backed down on its programme. This episode from February 2013 suggests that the state remains heavily dependent on the services of licensed *baladi* bread bakers to keep the population well supplied. The strong bargaining power of bakers allows them to better articulate their interests and preserve the status quo whereas the state struggles to stop them from overriding the market and diverting resources from the *baladi* bread system.

This is an area that merits additional research beyond this book, and the above paragraph identifies how some intermediaries can thwart reform. However, the jury is still out on how their bargaining power can vary with other actors.

**162.** State-owned bakeries can only cater for about 40% of the demand for *baladi* bread. The rest is relegated to privately-owned bakeries with a licence to produce *baladi* bread.

Finally, the study of rent-seeking behaviour in the *baladi* bread system provides a better sense of the loss borne by society. The original budgeted amount for the subsidy (\$3.1 billion) is in fact much lower when taking into account the distortions in the system. It would be difficult to get an accurate estimate of the actual cost of the *baladi* bread subsidy. However, the additional resources that are invested in selling *baladi* bread flour on the black market, bribing inspectors or obtaining licences contribute to further increasing the actual cost of the subsidy. The knock-on effect of this on the rest of the economy suggests a more nuanced reality for rent-seeking and income generation in Egypt. Future research avenues can then use this example to look at the broader structure of rent-seeking and incomes in Egypt.

By shedding light on the power of these intermediaries across the supply chain, it is easier to grasp how the *baladi* bread subsidy regime has exhibited tremendous path dependency and remained resistant to any radical changes over time.<sup>163</sup> The underlying distribution of decision-making power is concentrated amongst a select group of actors in the system that can then control how rents are administered at each stage. The emphasis on rents and reforms here is essentially the study of violence and social order frameworks made by Douglass North, John Wallis and Barry Weingast (2009). In their book of the same name, they emphasise the relation between rents and development.<sup>164</sup>

In a sense, the functioning of the *baladi* bread subsidy regime conforms to their description of a “limited access order” since there are insiders who benefit from the system.<sup>165</sup> The reason the whole *baladi* bread supply chain links together on a day-to-day basis is because each of those intermediaries has a continuing interest in ensuring access to those rent streams. Rent-seeking intermediaries that are studied in this chapter can then be regarded as rent coalitions, striving to preserve the status quo and adding up the transaction costs of the system.

The above discussion clearly reinforces a classical political economy insight that good economics may not always be good politics. This chapter and the book as a whole have more broadly shown that the politics of the *baladi* bread subsidy go beyond the concerns of consumers alone. In fact, they are surrounded by a whole range of intermediaries that act as rent coalitions, obstructing reform. The *baladi* bread subsidy regime can be seen as a microcosm of the Egyptian political economy. The study thus provides a neat window into understanding the broader underpinnings of the centralised state structure, bloated public sector and pervasive regulatory controls.

**163.** Path dependence is understood in the sense that certain socioeconomic outcomes are contingent on particular events from the past that themselves need not have occurred.

**164.** Violence and social orders is a conceptual framework that examines the logic of the social order in societies. It considers the interest of elites in power and their access to rent through limited access to activities, organisations and privileges. This group constitutes a collation that limits access to both the political and economic system through rent-seeking behaviour. Because these rents are reduced if violence breaks out, rent-seeking then enables elites to credibly commit to each other to limit violence.

**165.** For a description of limited access orders see North et al., 2009, p.21.

